



## **DRAFT 2007-LAz-20: Modify Ownership of PUV Property**

### **BILL ANALYSIS**

**Committee:** Revenue Laws  
**Introduced by:**  
**Version:**

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**SUMMARY:** *This draft modifies the present-use value property tax statutes as follows:*

**1. It changes the ownership requirements for business entities and trusts as follows:**

- *It expands the membership of a qualified business entity to include trusts and other business entities. Current law allows only a natural person to be a member of a business entity.*
- *It expands the beneficiary of a qualified trust to include a business entity. Current law allows the following to be beneficiaries of a qualified trust: a natural person who created the trust, the creator's relatives, and a second trust whose beneficiaries are currently entitled to receive trust income or principal and who are either creator of the first trust or the creator's relatives.*
- *It expands tenants in common to include a trust. Current law allows only a natural person or business entity to be a tenant in common.*
- *It clarifies that an individual may be a direct or indirect member of a qualified business entity or a direct or indirect beneficiary of a qualified trust.*
- *It clarifies that a qualified business entity does not include a corporation whose shares are publicly traded or who has a member that is a corporation whose shares are publicly traded.*

**2. It allows property to remain in present-use value if the owner pays deferred taxes at the time of transfer and the new owner continues to farm the land and files an application for present-use value status.**

**CURRENT LAW:** Since 1973, the General Assembly has provided special property tax treatment for farmland that is classified and used for agricultural, horticultural, or forest purposes.<sup>1</sup> If the farmland meets certain ownership and size requirements and is engaged in commercial production under a sound management program, the land may be appraised and taxed at its present-use value (PUV) as opposed to market value.<sup>2</sup> PUV is usually much less than market value. The difference between the taxes due on the PUV and taxes that would have been payable in the absence of the special tax treatment is known as deferred taxes. When the land becomes disqualified for PUV, the deferred taxes for the current year and the three previous years with interest will usually become due and payable.<sup>3</sup>

<sup>1</sup> During the 2007 Session, the agricultural land classification was amended to include agricultural land used as an aquatic species farm, effective in the 2008-2009 tax year.

<sup>2</sup> Agricultural and horticultural land must also meet an income requirement: the land must have one tract that produces at least \$1,000 average gross income over the three preceding years.

<sup>3</sup> No deferred taxes are due if the property loses its classification for one of the following purposes: (1) the land is enrolled in the federal Conservation Reserve Program and is no longer in production and therefore does not meet the income requirement, (2) the land is conveyed by gift to certain exempt organizations and governmental entities. This applies to

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One of the most complex parts of the PUV program is determining the ownership requirements in order to qualify for the program, particularly when the property is owned by a business entity or trust. The law requires that PUV property be "individually owned". Any of the following categories satisfy this definition:

- Natural person.
- Business entity – This term applies to limited liability companies, general partnerships, limited partnerships, and corporations. To satisfy the definition of "business entity", the entity must have agriculture, horticulture, or forestry as its principal business; all members of the entity must be natural persons; and all members of the business entity must be actively engaged in the principal business of the entity or be related to a member who is actively engaged in the principal business of the entity. Alternately, a member can be a relative of a decedent who met one or both of the above two conditions after the business entity had already qualified for PUV classification and from whom the member inherited his interest.
- Tenancy in common – This is a form of ownership where multiple owners (natural persons or business entities) can own individual interests in property.
- Trusts – The trust must be created by a natural person who transferred the land to the trust. Each beneficiary who is entitled to receive income or principal must be one of the following:
  - (a) The creator of the trust or a relative of the creator of the trust, or
  - (b) A second trust whose beneficiaries (currently entitled to receive income or principal) are all either the creator of the trust or a relative of the creator of the trust.
- Testamentary trust – The trust must satisfy all of the following requirements:
  - (a) Must be created by a natural person who transferred the land to the trust.
  - (b) Land must have qualified for classification in the hands of the natural person prior to the transfer to the trust.
  - (c) At the time of the creator's death, the creator had no relatives.
  - (d) Trust income, less reasonable administrative expenses, is used exclusively for educational, scientific, literary, cultural, charitable, or religious purposes.

## **BILL ANALYSIS:**

Ownership Modifications: In recent years, taxpayers have voiced concerns about the complexities and perceived unfairness of certain aspects of the ownership requirements for qualified farmland. In addition, county tax assessors, who must apply the PUV laws, have echoed concerns about the complexity of these requirements. Staff met with representatives of county tax assessors, the North Carolina Association of County Commissioners, the School of Government, the North Carolina Farm Bureau, and the Department of Revenue to discuss these issues. This group proposes the following changes to PUV ownership:

- Change the definition of "individually owned" as follows:
  - (a) The awkward reference to "'owned by a natural person" is changed to "owned by an individual".
  - (b) Members of a business entity are no longer restricted to individuals and will include trusts and other business entities. A qualified business entity, however, may not be a corporation whose shares are publicly traded and none of its members may be corporations whose shares

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conveyances by gift to nonprofit organizations where the property will qualify for exclusion from the tax base because it is real property that will be exclusively used for educational and scientific purposes as a protected natural area, or where the property will be exclusively used for nonprofit historic preservation purposes, or (3) the property is conveyed by gift to the State, political subdivisions of the State, or the United States.

are publicly traded. When the membership of a business entity includes a business entity or a trust, then all members of the business entity and all beneficiaries of the trust must be individuals. These individuals are deemed to be indirect members of the qualified business entity.<sup>4</sup> As in current law, the principal business of the business entity must be in agriculture, horticulture, or forestry, and each member must be actively engaged in one of these activities or related to a member who is actively engaged in one of these activities. Also if the land is leased, all members of the business entity must be individuals and relatives.

(c) Beneficiaries of a trust may be a business entity as long as the members of the business entity are individuals who either created the trust or who are relatives of the creator. These individuals are deemed to be indirect beneficiaries.

(d) A tenant in common may include a trust in addition to an individual and business entity.

The following are examples of land that would qualify for PUV under the proposed changes:

- A corporation applies for PUV. Four shareholders of the corporation are individuals who are actively engaged in farming the land and one shareholder is an LLC. The members of the LLC are all relatives of one of the individual shareholders. (Under current law, the corporation would not qualify because it has an LLC as a member.)
- Tenancy in common applies for PUV, and one of the tenants is a trust. (Under current law, the property would not qualify, because all tenants must be individuals or business entities.)
- An LLC applies for PUV, and one of the members of the LLC is a trust. All beneficiaries of the trust are children of the individual members of the LLC that owns the land. (Under current law, the LLC would not qualify because the trust is not an individual.)

Deferred Taxes Paid at Transfer: The property tax working group also proposes clarifying language that will allow land to remain in the PUV system if land currently in PUV is transferred to a new owner, but the deferred taxes are paid at the time the transfer occurs.

Under current law, there are several standard ownership requirements that a natural person or business entity must meet in order for their property to be in the PUV system:

- If the property is owned by a natural person, the property must meet one of the following requirements:
  1. The property is the owner's place of residence.
  2. The property has been owned by the current owner or a relative of the current owner for the four full years preceding January 1 of the year for which application is made.
  3. If transferring from a business entity or trust to the current owner, the property must have been qualified for and receiving PUV.
- If the property is owned by a business entity, the property must have been owned by the business entity or by one or more members of the business entity for the four full years preceding January 1 for which application is made.

An exception to these standard ownership requirements exists when land appraised at its PUV value is transferred to a new owner and the new owner (i) continues to use the land for its current PUV classification, (ii) files an application for PUV, and (iii) assumes the deferred taxes. However, this exception has been interpreted not to apply when the seller pays more than the current year's taxes at the

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<sup>4</sup> The indirect ownership determination does not stop at the first tier of the business entity that owns farmland. For example, if a business entity has as one of its members an LLC and one of the members of the LLC is another LLC, then the indirect ownership will apply to any member of the second LLC if the member is an individual who is actively engaged in farming the land or a relative of an individual who is actively engaged in farming the land.

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time of transfer. The seller is deemed to have voluntarily removed the property from the PUV program, and the new owner may have to wait four years to qualify for PUV. The draft would allow the land to remain in PUV when the seller pays the deferred taxes at time of transfer. The new owner will become liable for subsequent deferred taxes when the land becomes disqualified.

**EFFECTIVE DATE:** The draft is effective for taxes imposed for taxable years beginning on or after July 1, 2008. Notwithstanding G.S. 105-277.4(a), an application submitted for the 2008-2009 tax year for the classification of land owned by a business entity or trust is considered timely if it is filed on or before September 1, 2008.

*This summary quotes extensively from the "Present-Use Value Program" prepared by the Property Tax Division of the North Carolina Department of Revenue.*